Whiteside & Associates

Memo

From: Terry Whiteside

To: Montana Wheat & Barley Committee

Date: November 9, 2007

Re: Transportation Report

The Captive Rail Shippers are Active

UPDATE: EX PARTE 664 SUB NO. 1 – COST OF CAPITAL

REPLY COMMENTS FILED WITH STB IN EX PARTE NO. 664 – COST OF CAPITAL - THE HONORABLE BRIAN SCHWEITZER, GOVERNOR, STATE OF MONTANA; ALLIANCE FOR RAIL COMPETITION, MONTANA WHEAT & BARLEY COMMITTEE, COLORADO WHEAT ADMINISTRATIVE COMMITTEE, COLORADO ASSOCIATION OF WHEAT GROWERS, IDAHO BARLEY COMMISSION, IDAHO WHEAT COMMISSION, IDAHO GRAIN PRODUCERS ASSOCIATION, MONTANA GRAIN GROWERS ASSOCIATION, NEBRASKA WHEAT BOARD, NEBRASKA WHEAT GROWERS ASSOCIATION, OKLAHOMA WHEAT COMMISSION, SOUTH DAKOTA WHEAT COMMISSION, SOUTH DAKOTA WHEAT INC., TEXAS WHEAT PRODUCERS BOARD, TEXAS WHEAT PRODUCERS ASSOCIATION, WASHINGTON WHEAT COMMISSION, NATIONAL ASSOCIATION OF WHEAT GROWERS, NATIONAL BARLEY GROWERS ASSOCIATION

- The STB opened a proceeding to propose rule changes in how they determine the Cost of Capital. The STB is proposing to adopt a CAPM (Capital Asset Pricing Model) approach to determining the cost of capital thereby abandoning is long criticized discounted cash flow (dcf) methodology. Ten years ago, Dr. Alfred Kahn together with the Alliance for Rail Competition and captive shippers urged the STB to move to a CAPM methodology to more accurately reflect the 'real world' of railroading and their actual cost of capital. The Federal Reserve, and

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other federal regulatory agencies moved to CAPM years even decades ago because it produces a cost of capital that is more accurate.

- The significance of a move to CAPM will be to more accurately assess the real cost of capital for the railroads and thus redefine more accurately their need for revenue. It has long been held by captive rail customers that the railroads are and have been for a long time – revenue adequate (making record profits) and in a time of rail shortage of capacity, there is a real need for an accurate definition of revenue needs.
- On September 27, 2007, Montana Governor Brian Schweitzer partnering with the Alliance for Rail Competition (ARC) and joined by numerous members of ARC and a broad array of groups representing rail shippers of agricultural commodities filed COMMENTS with the federal Surface Transportation Board calling for changes in railroad industry cost of capital standards.
- **This proceeding is important for captive farm producers because it could lead to recognition that the nation's major railroads are financially strong, and no longer need to be protected from revenue inadequacy as the STB has done since 1980.**
- On October 29, 2007, the captive shippers together with Montana Governor Brian Schweitzer filed REPLY COMMENTS in this same proceeding.

  "The Opening Comments filed September 27, 2007 by the Honorable Brian Schweitzer, Governor of Montana, and various Agricultural Interests predicted that the Railroads would see the Board's proposal in this proceeding as a threat to a regulatory status quo that is highly favorable to their industry. That prediction has been confirmed by the Opening Comments filed by the AAR and separate Comments of the Class I Railroads."

  "What is surprising about the Railroads' Comments is how little substance there is to their criticisms of the Capital Asset Pricing Model ("CAPM") as a substitute for the Discounted Cash Flow ("DCF") approach to assessing the railroad industry's cost of capital. As AAR

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Witness Glenn Hubbard candidly acknowledges, "Neither model is inherently superior to the other, and ideally, both models should yield comparable results." Verified Statement at 3-4. See also the Verified Statement of AAR Witness Myers at 7: "I am not recommending that the Board reject the CAPM model and return to the sole reliance on the constant-growth DCF formula.""

- **In essence the railroads predictably continue to argue out of both sides of their mouth in front the STB and Congress – namely,**
  - **Railroad's argue that government intervention is necessary to insure that they earn "adequate revenues"**
  - **At the same time, railroads argue that NO GOVERNMENT intervention is necessary to limit their monopoly power!**

The captive shippers in their reply statement point out this duplicitous style of argument- "To a larger extent, however, the Railroads argue for a higher cost of capital based not on financial realities but due to the perceived regulatory advantages of continuing to be designated revenue inadequate."

These arguments are specious, for multiple reasons. "A particularly glaring defect in the Railroads' analysis is their failure to acknowledge the limited scope of the STB's rate reasonableness jurisdiction. See, e.g., the Verified Statement of AAR Witness Myers at 3: "I understand that railroads deemed revenue-adequate could face limits on what they can charge for transportation." "

"Witness Myers is a Professor of Economics and may have been misinformed, but Railroad witnesses who know better make similar claims. See the Verified Statement of UP Chief Financial Officer Knight at 8: "When the Board calculates the cost of capital, it effectively tells the company, our shareholders and financial markets the maximum level of returns that we will be allowed to achieve over time." This statement is simply false. Reflecting the same error is BNSF Chief Financial Officer Hund's warning (V.S. at 4-5): "If, however, the Board effectively caps BNSF's earning capacity at a

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level that does not reflect the real-world cost of capital, BNSF will be unable to justify continuing investment or, indeed, to attract the capital necessary for such investment."

"The STB has jurisdiction over rail rates only where market dominance is found, under 49 U.S.C. § 10707, and only the rates on captive traffic are required by law to be reasonable. 49 U.S.C. § 10701(d)(1). These restrictions exclude all freight moving at rates below the jurisdictional threshold, or where there is an absence of qualitative market dominance (i.e., where effective intermodal or intramodal competition exists), or where the freight is exempt."

"In recent testimony on Capitol Hill, Board Chairman Nottingham estimated that "less than 10% of the nation's freight rail traffic is recognized as captive and eligible for STB rate regulation." Testimony before House Committee on Transportation and Infrastructure Hearing on Rail Competition and Service, September 25, 2007, at page 1. The vast majority of rail freight in America is therefore not even potentially subject to a "cap" on railroad rates, and the Railroad witnesses' claims to the contrary are specious."

"The Class I railroads have been able to obtain financing on Wall Street for years despite consistent ICC and STB findings that they were revenue inadequate. Formal findings that they are revenue adequate should be good news for investors, just as reports of increased revenues are good news for investors in other industries."

"Indeed, the Railroads' future has never been brighter. As BNSF Witness Hund points out, "the demand for rail transportation, measured in tonnage, will increase by 88% by 2035". Capacity constraints facing other modes make it highly likely that railroads will be in a position not to lose market share to motor, water or air carriers. Even without improved service, Railroads may gain market share, and such gains are more likely if service improves. Inadequate investment in highway infrastructure, tolling of existing roads, congestion, driver shortages and environmental issues make any fears of massive diversion of freight from trains to trucks unrealistic, absent major (and highly unlikely) changes in current government policies."

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"The Railroads are also fond of arguing that their recent rate increases simply reflect fundamental laws of supply and demand. If this is the case, the Railroads can expect dramatic revenue gains from the 90% of their existing customers (as well as new non-captive customers), whom the Railroads can legally charge anything they like."

"The Railroads "cap" arguments do not make sense even in the context of the 10% of rail freight that is estimated to be subject to STB rate jurisdiction. As detailed in the Opening Comments filed in this proceeding by Governor Schweitzer and these Agricultural Interests, effective regulation of rail rates has been nonexistent for decades."